



and income tax consequences of the division of a trust and distribution of trust assets as described below.

### Facts

The facts submitted and representations made are as follows: Decedent died on Date 1, survived by Spouse, Child 1, and Child 2.

During Decedent's lifetime, Decedent and Spouse created and funded a revocable trust (Trust), naming themselves as co-trustees. Upon the death of either spouse, the survivor is to serve as sole trustee. In Article Fourth of her will, Decedent bequeathed the residue of her estate to Trust. Article 3 of Trust provides that at the death of the first spouse to die, the deceased spouse's testamentary bequests to Trust shall be added to Trust and then Trust shall be divided into 3 trusts: The Survivor's Trust, the Exemption Trust, and the Marital Trust. The Survivor's Trust shall contain the surviving spouse's one-half interest in community property and separate property. This trust remains revocable by the surviving spouse and, at that spouse's death shall be distributed in accordance with that spouse's general power of appointment.

The Exemption Trust shall consist of a pecuniary amount, determined under a formula, of the Trust assets attributable to contributions by the deceased spouse. The Marital Trust shall consist of the balance of such assets. The Trustee shall pay to the surviving spouse for life, in monthly installments, the net income of the Marital Trust. If such income payments are deemed insufficient, a Special Trustee (who is the individual named as Successor Trustee, and, in any event cannot be the surviving spouse) may pay the surviving spouse principal from the Marital Trust as the Special Trustee deems necessary for the proper care, maintenance, and support of the surviving spouse during any period of illness, or other want or necessity and the maintenance of the surviving spouse in the manner of living to which that spouse was accustomed at the date of the execution of Trust.

At the surviving spouse's death, the Trustee shall add the balance of the Marital Trust to the Exemption Trust and shall divide the Exemption Trust into equal shares for the living children of Decedent and Spouse and for any deceased child with issue surviving. Each share shall be held and administered as a separate trust. The Trustee of a separate trust for a living child under the age of 21 shall pay to or apply for the benefit of each child in monthly or other convenient installments so much of the net income of his or her trust, up to the whole thereof, as the Trustee in its discretion deems advisable for the child's proper care, support, maintenance, and education. The Trustee shall pay all of the net income to a child age 21 or older and principal for the child's proper care, support, maintenance, and education in such amounts as the Trustee in its discretion deems advisable. Principal will be distributed to a child: 1/3 at age 30, 1/2 at age 35, and the balance at age 40. The share of a child who dies before receiving the child's entire share will be held for the child's issue or, if none, added to the share for Trustors' other living children.

Section 6.03 of Trust provides a restraint on transfers as follows:

Except as otherwise expressly provided in this Declaration, no beneficiary of any Trust provided for in this Declaration shall have any right, power, or authority to alienate, encumber, or hypothecate his or her interest in the principal or income of such Trust in any manner, nor shall such interest of any beneficiary be subject to claims of his or her creditors or liable to attachment, execution, or other process of law.

Section 6.04 permits non-prorata funding as follows:

On any division of the assets of the Trust Estate into shares or partial shares and on any final or partial distribution of the assets of the Trust Estate or any Trust provided for in this Declaration, the Trustee, in its absolute discretion, may divide and distribute such assets in kind, may divide or distribute undivided interests in such assets, or may sell all or any part of such assets and make division or distribution in cash or partly in cash and partly in kind. The decision of the Trustee, either prior to or on any division or distribution of such assets, as to what constitutes a proper division of such assets of the Trust Estate or a Trust provided for in this Declaration shall be binding on all persons in any manner interested in any Trust provided for in this Declaration. The income tax bases of assets allocated or distributed non-prorata need not be equivalent and may vary to a greater or lesser amount, determined by the Trustee in his discretion, and no adjustment need be made to compensate for any difference in bases.

Decedent's federal estate tax return, Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, was timely filed. On Schedule M of the return, the Executor elected to treat Trust assets passing to the Marital Trust as qualified terminable interest property (QTIP).

Child 2 died without issue approximately two years after Decedent's death. Spouse is the Trustee and the income beneficiary of Marital Trust, and Child 1, currently aged 35, is the only living contingent remainder beneficiary. Child 1 has no issue.

On Date 2, Spouse, as Trustee of Marital Trust, petitioned Court for an order modifying Marital Trust, pursuant to State Statute 1, by dividing the trust into two trusts, Marital Trust A and Marital Trust B; and modifying Marital Trust B, pursuant to State Statute 2, by terminating that trust and distributing the assets. The Petition states that Marital Trust A will hold three-quarters of the assets of Marital Trust, and Marital Trust B will hold one-quarter of the assets. The assets will be divided between the two trusts on a non-prorata basis. After Marital Trust is divided into Marital Trusts A and B, Marital Trust B will be terminated. Upon the termination, Spouse and Child 1 will receive the actuarial present values of their respective interests in Marital Trust B. Accordingly,

Child 1 will receive  $x\%$  of the assets of Marital Trust B, and Spouse will receive  $y\%$  of the assets.

State Statute 1 relates to the division of trusts. It provides as follows:

On petition by a trustee or beneficiary, the court, for good cause shown, may divide a trust into two or more separate trusts, if the court determines that dividing the trust will not defeat or substantially impair the accomplishment of the trust purposes or the interests of the beneficiaries.

State Statute 2 relates to the modification or termination of a trust due to changed circumstances. It provides as follows:

(a) On petition by a trustee or beneficiary, the court may modify the administrative or dispositive provisions of the trust or terminate the trust if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust. In this case, if necessary to carry out the purposes of the trust, the court may order the trustee to do acts that are not authorized or are forbidden by the trust instrument.

(b) The court shall consider a trust provision restraining transfer of the beneficiary's interest as a factor in making its decision whether to modify or terminate the trust, but the court is not precluded from exercising its discretion to modify or terminate the trust solely because of a restraint on transfer.

In proceedings connected with the petition to Court, Spouse alleged that Child 1 has health complications. Child 1 submitted an affidavit explaining these health matters.

It is represented that Marital Trust currently holds marketable securities, cash, and stock in a closely-held corporation (Company). It is further represented that upon the division of Marital Trust into Marital Trusts A and B, Marital Trust A will hold all of the stock in Company and Marital Trust B will hold only marketable securities and cash. You have asked that we rule as follows:

1. The division of the Marital Trust into Marital Trust A and Marital Trust B by Court on a non-prorata basis will not be a recognition event for income tax purposes.
2. The termination of Marital Trust B and the distribution of its assets to the remainder and life beneficiaries, based on the actuarial present values of their

respective interests in Marital Trust B, will not be an income recognition event for Marital Trust B.

3. Upon termination of Marital Trust B and the distribution of its assets to the remainder and life beneficiaries, based on the actuarial present values of their respective interests in Marital Trust B, the beneficiaries will receive carry-over basis for income tax purposes on assets received from Marital Trust B.

4. The division of the Marital Trust into Marital Trust A and Marital Trust B by Court on a non-prorata basis will not disqualify the Marital Trust or Marital Trust A and Marital Trust B as QTIP trusts.

5. The termination of Marital Trust B will result in a gift under § 2519 of the Internal Revenue Code by the surviving spouse to the remainder beneficiary in the amount of the entire fair market value of the assets in Marital Trust B determined on the date of the disposition less the value of the qualifying income interest in the assets in Marital Trust B on the date of the disposition.

6. After the division of the Marital Trust into Marital Trust A and Marital Trust B, the subsequent termination of Marital Trust B will not cause Marital Trust A to fail to be qualified as qualified terminable interest property (QTIP) under § 2056.

### Law and Analysis

#### Rulings 1 & 2

Section 661(a) provides that in any taxable year a deduction is allowed in computing the taxable income of a trust (other than a trust to which subpart B applies), for the sum of (1) the amount of income for such taxable year required to be distributed currently; and (2) any other amounts properly paid or credited or required to be distributed for such taxable year, but such deduction shall not exceed the distributable net income (DNI) of the estate or trust.

Section 1.661(a)-2(f) of the Income Tax Regulations provides that gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under § 643(b) and the applicable regulations, if income is required to be distributed currently.

Section 662(a) provides that there shall be included in the gross income of a beneficiary to whom an amount specified in § 661(a) is paid, credited, or required to be distributed (by an estate or trust described in § 661), the sum of the following amounts: (1) the amount of income for the taxable year required to be distributed currently to such

beneficiary, whether distributed or not; and (2) all other amounts properly paid, credited, or required to be distributed to such beneficiary for the taxable year. If the sum of (A) the amount of income for the taxable year required to be distributed currently to all beneficiaries, and (B) all other amounts properly paid, credited, or required to be distributed to all beneficiaries exceeds the DNI of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to DNI (reduced by the amounts specified in (A)) as the other amounts properly paid, credited, or required to be distributed to the beneficiary bear to the other amounts properly paid, credited, or required to be distributed to all beneficiaries.

Section 61 provides that gross income means all income from whatever source derived. Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.

Rev. Rul. 56-437, 1956-2 C.B. 507, holds that the severance of a joint tenancy in stock under a partition action provided for by state law to compel the issuance of separate stock certificates is not a sale or exchange. Likewise the conversion of a joint tenancy in stock into a tenancy in common in order to extinguish the survivorship feature is a nontaxable transaction because the right of the property owners to partition is an inherent ownership right each party possessed under applicable state law.

Rev. Rul. 69-486, 1969-2 C.B. 159, involved two beneficiaries of a trust who by mutual agreement, requested that the trustee distribute all of the trust corpus consisting of notes to one of the beneficiaries and all of the trust corpus consisting of common stock to the other beneficiary. The trust instrument as well as local law was silent

regarding whether the trustee had the authority to make such a non-prorata distribution of property in kind. Because the trustee was not specifically authorized to make an allocation of specific property in kind, the beneficiaries were treated as having an absolute right to a ratable in-kind distribution. Rev. Rul. 69-486 treated the beneficiaries as receiving the notes and common stock prorata, followed by an exchange between the beneficiaries giving all of the common stock to one and all of the notes to the other. Since, in substance, an exchange between the beneficiaries was deemed to occur, Rev. Rul. 69-486 held that the beneficiaries recognized gain under §§ 1001 and 1002.

The present case is distinguishable from Rev. Rul. 69-486 because the trust instrument allows for non-prorata distributions. Also, the two trusts will have identical terms to those set forth in the Trust Instrument, and the rights of the beneficiaries to trust assets remain unchanged. Accordingly, based on the facts submitted and representations made, we conclude that the proposed division of Marital Trust into Marital Trust A and Marital Trust B on a non-prorata basis will not constitute a distribution under § 661; and the proposed division will not result in the realization by Marital Trust, Marital Trust A, Marital Trust B, or by any beneficiary of any of these trusts, of any income under § 662. In addition, the proposed division of Marital Trust into Marital Trust A and Marital Trust B will not constitute a taxable disposition of trust assets for federal income tax purposes and the trusts and beneficiaries will not realize gain under § 1001 as a result of the division.

If, under local law, the trustee is authorized to terminate Marital Trust B and distribute its assets to the remainder and life beneficiaries, the proposed termination and distribution will be by operation of law and will not be a sale or other disposition with respect to Marital Trust B. Thus, based upon the facts submitted and the representations made, and assuming the transaction is effectuated substantially as described, we conclude that the termination and distribution will not be an income recognition event for Marital Trust B under § 1001. Further, we conclude that the termination of Marital Trust B and the distribution of its property to Spouse and Child 1 is not a distribution described in § 1.661(a)-2(f) and therefore does not result in the realization of gain or loss by Marital Trust B.

### Ruling 3

Section 643(e)(1) provides that the basis of any property received by a beneficiary in a distribution from an estate or trust shall be (A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for (B) any gain or loss recognized to the estate or trust on the distribution.

Section 643(e)(2) provides that in the case of any distribution of property (other than cash), the amount taken into account under §§ 661(a)(2) and 662(a)(2) shall be the lesser of (A) the basis of such property in the hands of the beneficiary (as determined under § 643(e)(1)), or (B) the fair market value of such property.

Based upon the facts submitted and the representations made, and assuming the transaction is effectuated substantially as described, we conclude that the termination of Marital Trust B and the non-prorata distribution of its cash and noncash property to Spouse and Child 1 is a distribution described in § 643(e)(1) (unless an election is made under § 643(e)(3)) and therefore the basis of such property received is the adjusted basis of such property in the hands of Marital Trust B immediately before the distribution. Spouse and Child 1 will take into their gross income their respective pro rata shares of Marital Trust B's distribution as provided by §§ 643(e)(2) and 662. Rulings 4, 5 & 6

Section 2001(a) imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Section 2056(a) provides that, except as limited by § 2056(b), the value of the taxable estate is to be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property that passes or has passed from the decedent to the surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Section 2056(b)(1) denies the marital deduction for an interest in property passing to the surviving spouse that is a "terminable interest." An interest passing to the surviving spouse is a terminable interest if it will terminate or fail on the lapse of time or on the occurrence of an event or contingency or on the failure of an event or contingency to occur and, on termination, an interest in the property passes to someone other than the surviving spouse.

Section 2056(b)(7) provides an exception to the terminable interest rule in the case of qualified terminable interest property (QTIP). Under § 2056(b)(7)(A), qualified terminable interest property is treated as passing to the surviving spouse for purposes of § 2056(a), and no part of the property is treated as passing to any person other than the surviving spouse for purposes of § 2056(b)(1). Section 2056(b)(7)(B)(i) provides that the term "qualified terminable interest property" means property: (i) which passes from the decedent; (ii) in which the surviving spouse has a qualifying income interest for life; and (iii) to which an election under § 2056(b)(7)(B)(v) applies.

Section 2501 imposes a tax on the transfer of property by gift. Section 2511 provides that the gift tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2519 provides that for gift tax purposes any disposition of all or part of a qualifying income interest for life in any property for which a deduction was allowed under § 2056(b)(7) is treated as a transfer of all interests in such property other than the

qualifying income interest. The transfer of the qualifying income interest is a transfer subject to gift tax under § 2511.

Section 25.2519-1(a) of the Gift Tax Regulations provides that a transfer of all or a portion of the income interest of a spouse in QTIP property is a transfer by the spouse under § 2511. Section 25.2519-1(c) provides that the amount treated as a transfer under § 2519 upon a disposition of all or part of a qualifying income interest for life in QTIP property is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under § 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. The gift tax consequences of the disposition of the qualifying income interest are determined separately under § 25.2511-2.

Under § 25.2519-1(f), the sale of qualified terminable interest property, followed by the payment to the donee-spouse of a portion of the proceeds equal to the value of the donee-spouse's income interest, is considered a disposition of the qualifying income interest.

The term "disposition," as used in § 2519, applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means. H. Rep. No. 201, 97<sup>th</sup> Cong., 1<sup>st</sup> Sess. 161 (1981).

Rev. Rul. 98-8, 1998-1 C.B. 541, holds that, if a surviving spouse acquires the remainder interest in a trust subject to a QTIP election in connection with a transfer by the surviving spouse of property or cash to the holder of the remainder interest, the surviving spouse makes a gift both under § 2519 and §§ 2511 and 2512. The amount of the gift is equal to the greater of (i) the value of the remainder interest (pursuant to § 2519), or (ii) the value of the property or cash transferred to the holder of the remainder interest (pursuant to §§ 2511 and 2512). In the revenue ruling, the surviving spouse, the income beneficiary of a QTIP trust, acquired the remainder interest from the remainder beneficiary in exchange for a promissory note; the trustee distributed all of the QTIP trust assets to the surviving spouse who paid off the note with some of those assets. At the conclusion of the transaction, the QTIP trust was terminated, and each beneficiary held assets equal to the actuarial values of their respective interests in the trust. The revenue ruling states that this transaction was essentially a commutation of the surviving spouse's income interest. The revenue ruling further states that a commutation, which is a proportionate division of trust property between the life beneficiary and remainder beneficiary based on the respective values of their interests is, in the context of a QTIP trust, a taxable disposition by the spouse of the qualifying income interest, resulting in a gift under § 2519 of the value of the remainder interest. The commutation of the surviving spouse's income interest in the QTIP trust is essentially a sale of the income interest by the spouse to the trustee (or the remainder

beneficiary) in exchange for an amount equal to the value of the income interest. The revenue ruling states that sales and commutations are expressly characterized as dispositions in the applicable legislative history and regulations.

In the present case, Spouse has a qualifying income interest for life in Marital Trust, and Child 1 is the remainder beneficiary. Following the proposed division of the Marital Trust into Marital Trusts A and B, Spouse will have a qualifying income interest for life in both Marital Trust A and Marital Trust B, and Child 1 will be the remainder beneficiary of both Marital Trust A and Marital Trust B. The division of Marital Trust into Marital Trust A and Marital Trust B will not affect the beneficial interests in Marital Trust. Therefore, based on the facts submitted and representations made, we conclude that the division of Marital Trust into Marital Trust A and Marital Trust B by Court on a non-prorata basis will not disqualify the Marital Trust or Marital Trust A and Marital Trust B as QTIP trusts.

In the present case, after the proposed division of Marital Trust into Marital Trusts A and B, Marital Trust B will be terminated, and Spouse and Child 1 will each receive the actuarial present values of their respective interests in Marital Trust B. This proportionate division of Marital Trust B property between Spouse and Child 1 will be a commutation similar to the transaction in Rev. Rul. 98-8. Therefore, Spouse will be treated under § 2519 as making a disposition of his qualifying income interest in Marital Trust B. See § 25.2519-1(f) and Rev. Rul. 98-8. Accordingly, based on the facts submitted and representations made, we conclude that Spouse will be treated as making a gift for federal gift tax purposes of an amount equal to the value of the Marital Trust B property reduced by the present value of Spouse's income interest in Marital Trust B. We further rule that, after the division of the Marital Trust into Marital Trust A and Marital Trust B, the subsequent termination of Marital Trust B will not cause Marital Trust A to fail to be qualified as qualified terminable interest property (QTIP) under § 2056.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code. In addition, this ruling is contingent upon all of the parties with an interest in Marital Trust (including Spouse, Daughter, and a guardian ad litem representing any unnamed remainder beneficiaries and any remainder beneficiaries not in being) obtaining a valid court order from Court dividing Marital Trust into Marital Trust A and Marital Trust B and terminating Marital Trust B consistent with the law of State as applied by the highest court in that state.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,

Katherine A. Mellody  
Senior Technician Reviewer, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures

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Copy of this letter